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International Economic & Energy Weekly

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17 **Key LDC Debtors: Grappling With Capital Flight** 25X1

Capital flight, which we estimate has bled over $180 billion from the key LDC debtors over the past decade, remains an obstacle to the solution of their international financial problems. Unless the debtors implement structural reform, which would remove the powerful incentives for capital outflows, we believe their financial straits will persist, multiplying economic problems and undermining political stability 25X1

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23 **Syria: Limited Help From Domestic Oil Gains** 25X1

Oil from Syria's new Thayyem field will only marginally strengthen Syria's economy, but will make Damascus less dependent on Iran for concessional oil shipments. Syria will continue to run a large current account deficit and suffer chronic foreign exchange shortages, which will add to President Assad's political problems. 25X1

[redacted] 25X1

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Perspective

OPEC: Implications of the Production Agreement [redacted] 25X1

OPEC's decision to return to adherence to a quota system is in line with Saudi Arabia's objective of garnering producer cooperation and fulfills Iran's goal of increasing prices. Strict compliance could push prices substantially above current levels in the near term. If the agreement collapses, however, and the Saudis renew the price war, oil prices could fall below current levels for an extended period. [redacted] 25X1

The agreement calls for OPEC production of about 16.6 million b/d during September and October, some 3.6 million b/d below current levels. The burden of the cuts will fall on Saudi Arabia, Kuwait, and the UAE—Iraq is not bound to a production quota. Prices are expected to remain volatile over the near term. Market psychology and a sharp cut in OPEC output could push the average world oil price to about $15 per barrel in the near term from its current $11 per barrel range. Spot prices for some crudes have increased by $5 since Monday. [redacted] 25X1

Considerable uncertainty remains over OPEC's ability to reduce its output to the target level. Past trends suggest that the membership will not abide by the quotas. The UAE reportedly was particularly reluctant to agree to the proposal and probably will be slow to comply. Substantial distrust exists among members, and they have warned that violations—even if marginal—would lead to a rapid collapse of the agreement. OPEC plans to monitor member compliance but has no enforcement mechanism. Most OPEC producers realize the consequences of indiscipline, however, and might be cautious about attempting to recoup this year's losses by exceeding their quotas. Indeed, the financial pain producers have experienced in recent months and the prospect of still greater losses in a continued price war may well encourage greater adherence to the scheme. Promises of support from some non-OPEC producers—including Mexico and Malaysia—may also encourage OPEC discipline. [redacted] 25X1

The Saudi strategy to increase its market share enacted last September was designed to raise near-term revenues, to force other producers to reduce output, and to ensure a long-term market for their oil. Although the Saudis probably hoped that oil prices would stabilize at about $15 per barrel—an amount that would generate the minimum required revenues at their quota level—excess production by other OPEC members forced prices to fall further. The Saudi policy also succeeded in cutting Iran's oil revenues, an incidental but desirable result in Riyadh's view. The new agreement is in line with Saudi Arabia's basic objectives. Despite absorbing the largest production cut, Riyadh has succeeded in getting other members to share in the reductions and would remain the world's largest oil exporter, an important Saudi objective. [redacted] 25X1

OPEC Oil Production, 1986

Million b/d

	Old Quota	July	New Quota
Total	16.00	20.2	16.65
Algeria	0.66	0.7	0.66
Ecuador	0.18	0.3	0.23
Gabon	0.14	0.2	0.14
Indonesia	1.10	1.4	1.19
Iran	2.30	2.2	2.30
Iraq	1.20	1.8	1.80 [a]
Kuwait [b]	0.90	1.6 (1.5)	0.90
Libya	0.99	1.1	0.99
Nigeria	1.30	1.5	1.30
Qatar	0.28	0.3	0.28
Saudi Arabia [b]	4.35	6.0 (5.8)	4.35
UAE	0.95	1.5	0.95
Venezuela	1.56	1.6	1.56

[a] Current Iraqi export capacity; Iraq was not assigned a formal quota.
[b] Amount in parentheses excludes Neutral Zone production, which is divided between Saudi Arabia and Kuwait and included in their quotas; the Neutral Zone has no quota of its own.

[redacted] 25X1

Tehran considers the agreement a success because it will boost prices without Iran having to cut output. Iran also will view the agreement as a victory for its campaign of intimidation against Saudi Arabia and the Gulf states, highlighted by its attacks earlier this year on Saudi ships and by the probable Iranian-sponsored sabotage of Kuwaiti oil facilities. Tehran will claim that its lobbying convinced the other OPEC members to unite in pressing Riyadh to reach an agreement. [redacted] 25X1

The Saudis still hold the trump cards, and if other OPEC members fail to adhere to the agreement Riyadh will have little incentive to restrain output. Faced with quota violations by other members, the Saudis probably would renew the market share fight and force prices down again. If OPEC members were to join the fight and attempt to force their remaining excess capacity—currently about 4 million b/d—onto the market, oil prices could fall to about $5 per barrel, their lowest level in real terms since before the Arab oil embargo in 1973. In the absence of producer cooperation, some industry analysts believe that oil prices would then remain below $10 for two years before market forces led to a rebound. [redacted] 25X1

Although not specifically an anti-US policy, an attempt by Riyadh to keep prices low would hurt oil exploration and development activity in high-cost areas such as the United States, Canada, and the North Sea. If prices held at around $5 per barrel for an extended period, domestic political pressures in many countries would force a reevaluation of oil and economic policies. [redacted] 25X1

[redacted] 25X1

Australia: Politics of Wheat Exports Roils Relations With the United States

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With national elections less than 18 months away, Prime Minister Hawke is concerned about the effects of the US Export Enhancement Program (EEP) on Australia's wheat sales next year. Wheat farmers have been hardest hit by declining commodity prices, and Hawke undoubtedly believes he cannot afford to ignore their pleas to use his claimed "special relationship" with the US administration to win them relief. Moreover, wheat farmers are traditionally the most vocal of Australia's relatively militant farmers and exert more political pressure than their numbers would indicate. Some members of Hawke's government are urging him to use the US-Australian joint defense facilities as a bargaining chip, but we doubt this linkage will be made in the bilateral ministerial beginning 10 August in San Francisco.

Farmers' Influence Down Under

Farmers—who provide more than one-third of Australia's export income—have been hurting the past years.[1] The value of agricultural production fell 21 percent in 1985, largely because of low commodity prices, and probably will fall another 21 percent in 1986, according to the Australian Bureau of Agricultural Economics. Despite high yields, more than one-half of the country's grain farms suffered net losses this year. According to our estimates, average farm income on family farms for the year ending 30 June 1986 fell below $5,000, less than an Australian family can collect from welfare programs.

Under these conditions, farmers have combined their economic leverage with militant tactics to gain political concessions from Canberra. In July 1985, 40,000 farmers marched on the capital, and five months later a group from New South Wales dumped 30 tons of wheat on the Parliament steps to protest low prices—$135 a ton in December 1985 versus $90 now—and high domestic interest rates. These tactics apparently brought results. During the first quarter of this year, Hawke granted special tariff rebates on fertilizer imports and tax rebates on farm fuel, primarily to prevent the Labor Party from losing its control of several states in elections early this year. The Prime Minister remains vulnerable to farmer dissatisfaction because the loss of nine of the Labor Party's 12 rural seats in the House of Representatives in the next national election—which must be held by January 1988—would topple the Hawke government.

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To complicate Hawke's political future, growth in the nonfarm sectors has slackened as a result of the weakness in world commodity prices. Real economic growth is likely to be less than 2 percent this year— 25X1
compared with 4.5 percent last year—and unemployment has risen slightly to about 8 percent. The current account deficit continues to widen, despite the 27-percent depreciation of the Australian dollar in the last 18 months, which in itself has contributed to an inflation rate of over 9 percent annually. In addition, after a three-year lull in industrial turmoil—primarily due to the government taking an active part in wage negotiations—Australia's trade unions last month began a series of strikes that we believe is likely to continue until at least September, when preparations for new wage negotiations will begin. 25X1

The EEP and the Market for Wheat

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From Hawke's perspective, the EEP darkens an already grim export outlook. International wheat prices are plunging because of high world wheat stocks, stagnant demand, and rapidly increasing production both in traditional wheat exporting countries and in former major wheat importers—such as Brazil, China, and the EC. World stocks now total over a full year's trade. Major grain producers are adopting aggressive export tactics to compete in this environment including low-interest credit terms, attractive freight rates, and direct export subsidies to boost sales 25X1
to the major cash buyers—the USSR, China, and Japan.

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[1] Wheat is the most important crop, involving 45,000 farms and about 25 percent of the country's farmers. This year 98 percent of Australia's wheat production was exported.

US Farm Policy and the World Wheat Picture

The 1985 US Farm Bill—in effect for the next five years—was designed to make US grain exports more competitive. It mandated a $1 billion, three-year Export Enhancement Program (EEP) to promote US sales and reduced rates on loans to US farmers. The EEP offers payment-in-kind crop bonuses from government stocks to promote exports to targeted markets where the United States faces competition from heavy subsidizers such as the EC. The United States has provided assurances that subsidies would be targeted to these markets and would not harm other US allies or nonsubsidizers. Last month proposals were made to broaden the EEP to include all traditional US grain customers—including the USSR and China.

The US wheat price sets a floor price for other wheat exporters. Under US farm legislation, wheat farmers take out loans to finance production using their potential wheat crop as collateral. The wheat price set by the government and used to calculate a farmer's loan amount, called the loan rate, acts as a guaranteed minimum price because the farmer can forfeit his crop to the US Government if the world price falls below the loan rate. In recent years, high US loan rates have propped up global wheat prices and, in combination with required sizable US acreage reductions, provided a powerful incentive to other nations to boost grain production.

The new US farm policy is likely to raise US farm export volume but sharply depress world grain prices over the next few years. According to some economists, world farm commodity prices could drop 50 percent below last year's levels and stay low for the next five years

Since the US Farm Bill was passed in December 1985, Australian farmers have appealed to Hawke to use the US-Australian alliance as leverage to protect their markets against subsidized US exports. In April 1986, after the United States offered wheat under the EEP to North Yemen—traditionally an almost exclusively Australian market—Hawke traveled to Washington specifically to appeal for a halt to such sales.

Potential Effects on Other Allies

In addition to Australia, the expanded EEP will sharply depress the export earnings and trade outlook for other major wheat exporters—including Canada, the European Community, and Argentina. Any US action that displaced sales to the USSR, Canada's most important market—a new Canada-USSR long-term grain agreement is scheduled to be signed this fall—would politically damage Prime Minister Mulroney. He feels the plan would force Ottawa to match US subsidies in order to maintain the Canadian market share, thereby undermining his efforts to control Canada's budget deficit. 25X1

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The EC also considers the USSR an especially important market because of its size and closeness, and US subsidies would fuel EC suspicions that the United States is directly attacking its Common Agricultural Policy. Even without US subsidies, lower world grain prices expected this marketing year as a result of the new US Farm Bill could add $1 billion to the cost of EC export subsidies. As a result, the EC would react strongly to subsidized sales to the USSR and would almost certainly match them in the short term. 25X1

Argentina will also be severely affected. The USSR is Argentina's largest trading partner and purchased a near-record 4 million tons of wheat in 1985/86. Under pressure to boost exports to maintain debt service payments, Buenos Aires would decry US subsidies as hypocritical, and the position of political groups favoring a debt moratorium could be strengthened. The US subsidy would probably discourage Argentina's increasing willingness to support inclusion of services in the new GATT round. 25X1

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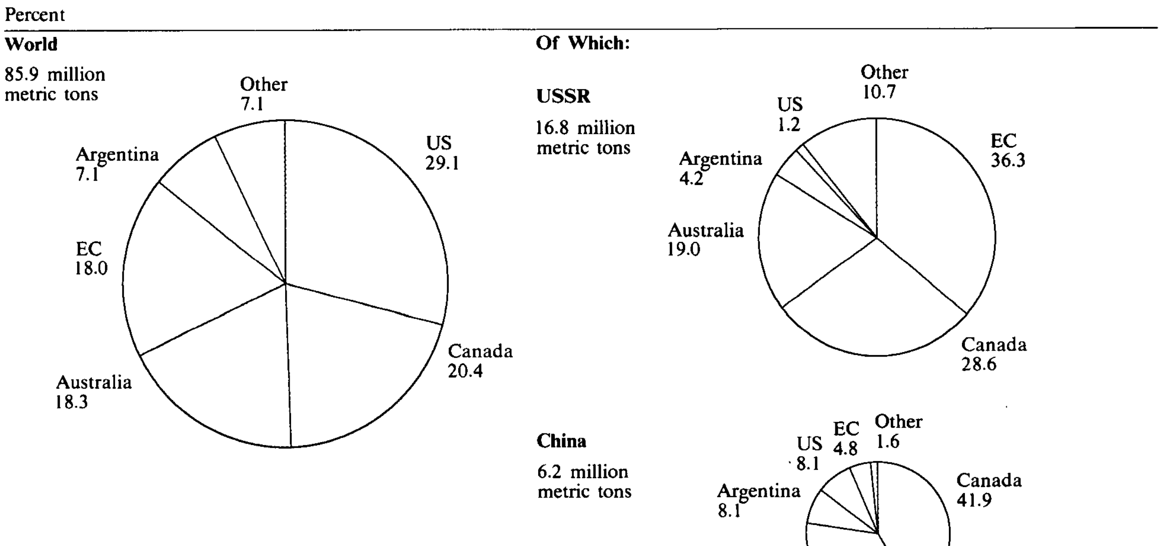
Hawke's visit disappointed many farmers, according to domestic press reports, because they concluded he achieved no concrete results. 25X1

World Wheat Export Market Share in 1985-86[a]



[a] Marketing year 1 July - 30 June.
[b] US wheat sales to the USSR this year total only 153,000 tons—far below historical levels of 4 to 6 million tons.

[redacted] 25X1

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The US decision last week to include 4 million tons of wheat for the USSR in the EEP is of special concern to Canberra. Farmers have reacted vehemently because the USSR, China, and Egypt are Australia's largest wheat customers. Farmers' complaints have prompted Hawke to call Washington directly and send a parliamentary delegation to lobby against pending legislation to permanently include the USSR and China in the EEP. For their part, the Soviets are already looking to take advantage of the situation. Soviet trade representatives in Canberra suggested during a press conference last week that despite the US subsidized prices Australian wheat might be attractive next year if the quality and terms of sale are favorable. [redacted] 25X1

Estimating the Costs

We believe Hawke has reason to be concerned about the effects of the EEP on the election. In the short term, Australia could lose as much as $20 million in export revenue this year if the proposed expansion of the EEP enabled the United States to win likely Chinese wheat purchases over the next two months that we estimate could total 200,000 tons. [redacted] 25X1

Australian Wheat Revenues:
Impact of the EEP, 1986/87 [a]

	Without EEP (US $90 per metric ton) [b]		With EEP (US $75 per metric ton) [b]		Revenue Loss *(million US $)*
	Volume *(million metric tons)*	Value *(million US $)*	Volume *(million metric tons)*	Value *(million US $)*	
World	16.5	1,485	16.5	1,240	245
USSR [c]	3.2	290	3.2	240	50
China [c]	2.3	210	2.3	175	35

[a] Volume is based on the 1985/86 levels.
[b] The $90 price for next year is the Chase Econometrics' estimate of the US wheat export price next year, taking into account the effects of the US Farm Bill but not an extension of the EEP. The $75 price is the world price we estimate would prevail with an EEP extension.
[c] The table above does not show the effects of the EEP on the quantity of wheat Australia might sell. According to our estimates, if the EEP is extended to the USSR and the Soviets next year buy the full amount of wheat specified in their current US long-term agreement (4 million tons), Australia's sales to the Soviets in 1986/87 could fall from an estimated 3 million tons to 1.5 million tons, cutting revenues by $155 million. China has not entered long-term agreements for wheat purchases since 1983. Thus we are less able to predict how much wheat China would import from Australia or the United States in 1986/87, although industry and USDA analysts estimate China's wheat imports are likely to be the same as or slightly less than this year, barring major crop disasters.

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Hawke, however, is probably worried more about the overall effects of the EEP on wheat prices. We estimate next year's price will fall to $75 per ton if the EEP expansion becomes effective. In this case, Australia stands to lose as much as $245 million on its wheat exports in 1986/87. It is conceivable that Australia could lose even more revenue—if the quantity sold also falls—but Australia so far has competed aggressively with EEP sales—by offering, for example, liberal credit programs or discounts for cash purchases. For this reason we expect Australia to maintain its current volume share.

The US Connection

Although Foreign Minister Hayden stresses that security issues and trade issues will not be linked in the San Francisco talks, some members of Hawke's government—echoing popular sentiments—say that Australia should use the US-Australian joint facilities as a bargaining chip in attempts to thwart further expansion of the EEP. We do not believe the Australian participants will directly threaten to close the facilities, but, if the proposed expansion becomes law, tensions will be high and such a threat will remain just below the surface.

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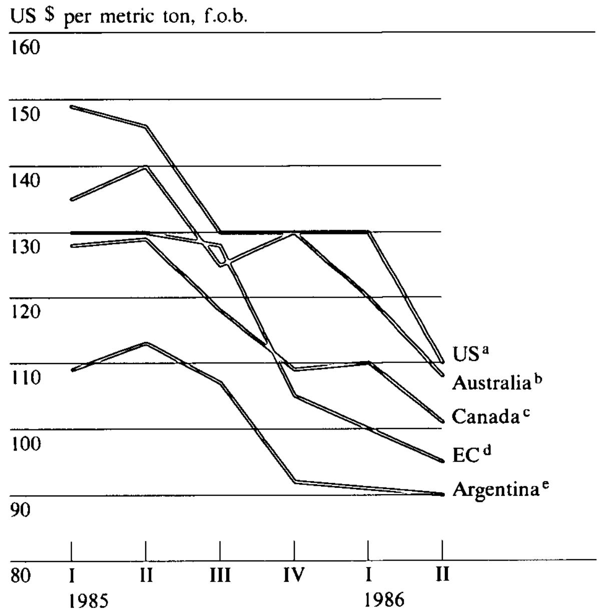
Representative Export Sales Prices for Wheat, 1985-86



[a] Gulf no.2 hard red wheat
[b] Standard white
[c] Vancouver no.1 western red spring
[d] French soft
[e] Buenos Aires

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Colombia: Economic Challenges for the New Administration 25X1

President Barco takes office this week with the benefit of an improving economy. The recent coffee price windfall and government stabilization measures have slowed inflation, strengthened the external accounts, and boosted economic growth. The new president, nonetheless, needs to tackle high unemployment, control inflationary pressures, and prevent mismanagement of the coffee bonanza. 25X1

Current Situation

Colombia is experiencing a healthy recovery from the economic stagnation that greeted President Betancur four years ago. Lower government spending and new taxes cut the public deficit in half in 1985. Leading Colombian firms refinanced their foreign debts, halting the erosion of foreign exchange reserves, according to local banking sources. The ailing financial system—which has suffered from a lack of liquidity, widespread domestic corruption, and insider loans made by the banks—is in better shape than a year ago, and domestic interest rates are set by market forces. Relaxed import controls have reduced shortages of manufacturing and agricultural inputs. The subsequent impact on prices has helped keep inflation at 10 percent for the first six months of 1986—the government goal is 22 percent for the year. 25X1

Colombia's President

El Tiempo ©

Virgilio Barco Vargas
Age 64 . . . experienced politician and diplomat . . . attended MIT and Boston University . . . studied engineering, economics, social sciences . . . as mayor of Bogota (1966-69), transformed city into modern urban center . . . Agriculture Minister, 1963-64 . . . as World Bank executive director (1969-74), spoke for five Latin American nations . . . strong supporter of extradition treaty, which he signed as ambassador to the United States (1977-81). 25X1

This year's rebound in world coffee prices and lower world interest rates have improved Colombian external accounts. New oil production has made the nation self-sufficient, eliminating $300 million in yearly oil import bills. Moreover, oil and coal exports will be roughly double last year's level. During the 12-month period ending in May, coffee earnings and capital repatriation—in response to more attractive domestic interest rates—pushed the foreign exchange reserves up 43 percent to about $2 billion.

Nonetheless, Colombia's two-year stabilization program has slowed the domestic economy. Official statistics indicate that real GDP grew only 2.5 percent in 1985, down from 3.2 percent in 1984, as a result of austerity policies that reduced consumer demand. Mining and construction revived this spring, but agriculture and commerce remain depressed. Moreover, unemployment is at a record 15 percent. Bogota has issued bonds and accelerated payments for imports and debt service to dampen the growth in the money supply, generated by the coffee windfall. Although monetary stabilization measures have taken out of circulation about 50 billion pesos since January, the money supply is growing at an average annual rate of 38 percent—the highest rate since 1978. 25X1

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Colombia: Foreign Financing Gap

Million US $
(except where noted)

	1982	1983	1984	1985 [a]	1986 [b]
Current account balance	−2,885	−2,826	−1,994	−1,305	−320
Trade balance	−2,076	−1,317	−312	9	1,365
Exports, (f.o.b.)	3,282	3,147	3,668	4,036	5,630
Coffee	1,577	1,536	1,799	1,575	2,735
Oil	279	378	445	300	600
Coal				104	240
Imports, (f.o.b.)	5,358	4,464	3,980	4,027	4,265
Net services and transfers	−809	−1,509	−1,682	−1,314	−1,685
Interest on debt	649	739	1,086	1,112	1,120
Debt amortization	429	636	700	767	950
Financial gap	**−3,314**	**−3,462**	**−2,694**	**−2,072**	**−1,270**
Direct investment	337	514	411	729	450
New medium- and long-term capital inflows (net)	1,322	983	1,278	1,173	1,870
Short-term capital and errors and omissions (net)	314	−449	−848	73	1,105
Other financial items					
External debt (end of year)	10,287	11,035	11,035	11,966	13,000
Short-term debt	3,109	2,872	2,230	1,966	2,000
Debt service ratio (percent) [c]	32	29	33	34	43
Foreign exchange reserves (end of year) [d]	3,861	1,901	1,364	1,595	2,500

[a] Estimated.
[b] Projected—assumes Bogota maintains its stabilization program.
[c] As a share of exports of goods and services.
[d] Excludes gold.

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Barco's Strategy

In his campaign, Barco emphasized the need for agricultural and industrial development, economic diversification, and increased foreign investment. He promised to create jobs, accelerate agrarian reforms, and improve provision of basic services. He believes the expansion of agricultural production could help counter the rural insurgency by offering employment opportunities for landless peasants who have been natural recruits for the guerrilla groups that have plagued the country for nearly 40 years. Barco is also likely to increase government spending in health, education, and communications, and at least continue construction of low-cost housing projects. We believe Barco will court foreign investors to accelerate economic growth and facilitate the transfer of technological know-how. At a recent meeting with foreign oil company officials, for example, the President reportedly was receptive to new investment offers.

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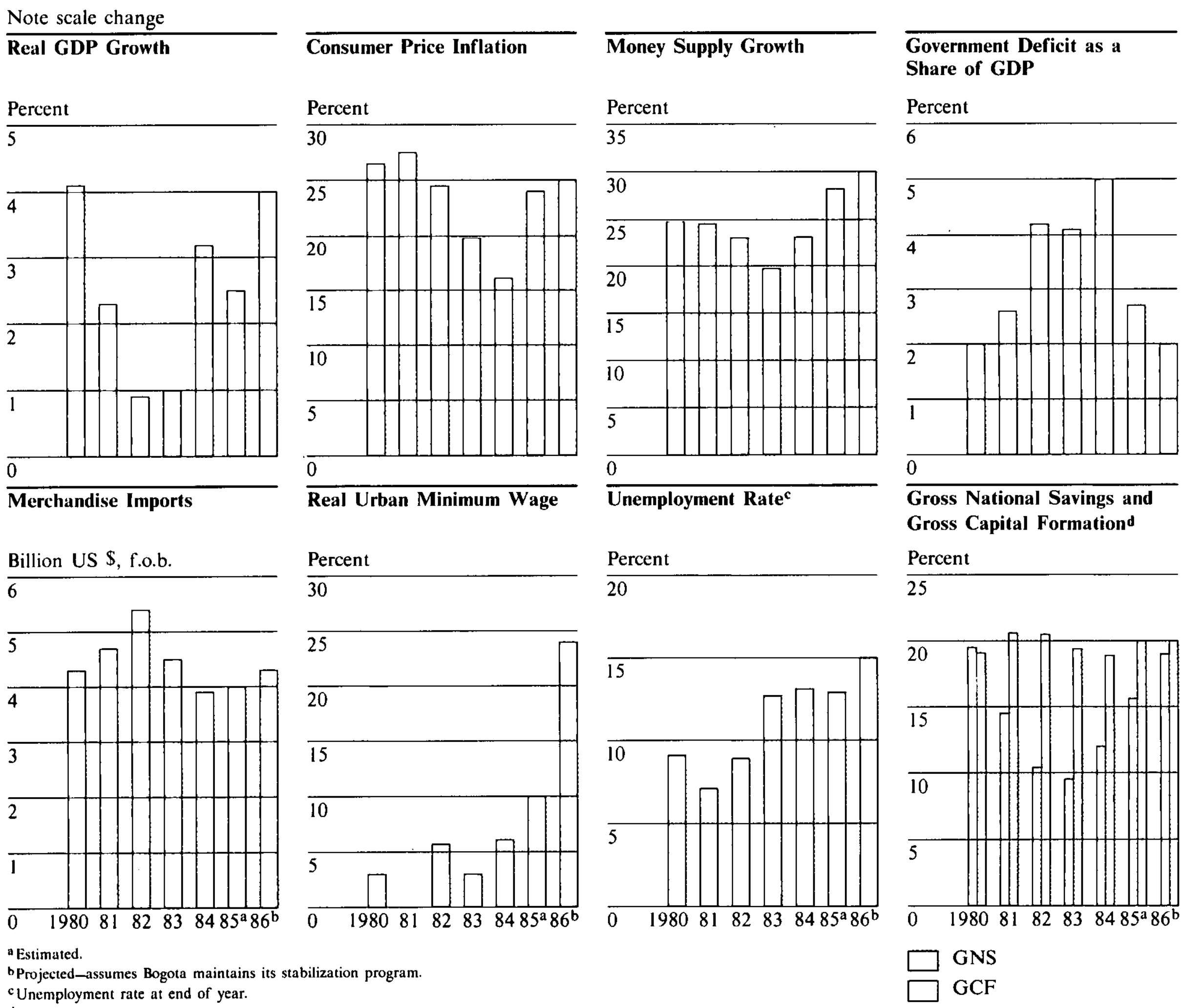
Prospects

Strong external accounts should facilitate Colombia's economic growth through 1987. Most econometric services forecast GDP growth at 4 percent for 1986, a $1 billion loan is on tap from international bankers,

Colombia: Selected Economic Indicators, 1980-86



[a] Estimated.
[b] Projected—assumes Bogota maintains its stabilization program.
[c] Unemployment rate at end of year.
[d] As a share of GDP.

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and a voluntary—and successful—stabilization program monitored by the IMF is in place. The new president's greatest fiscal challenge will probably be to limit inflation and prevent mismanagement of the current coffee bonanza, which may produce nearly $3 billion in foreign exchange earnings this year. Despite the government's success in keeping inflation down during the first half of this year, gains in wages and a flexible devaluation policy may result in an annual rate of about 25 percent. The chief danger is a pattern of short-term planning that has characterized previous Colombian policymaking in similar situations and contributed to the serious weakening of the economy during the last coffee boom (1976-78). 25X1

The Role of Narcotics and Other Contraband in the Colombian Economy

The US Embassy reports that, as a share of GDP, illegal earnings from cocaine and marijuana smuggling have increased since mid-1985. The estimated annual value of illegal drugs produced or processed in Colombia has fluctuated from $400 million to at least $1.6 billion over the past five years [redacted] 25X1 *Drug earnings are Colombia's second most important source of foreign exchange after coffee. Illegal earnings from the drug trade were equivalent to about 20 percent of total legal exports in 1985, up from 12 percent in 1983, but not all these revenues returned to Colombia. In addition, the US Embassy reports that illicit imports—mainly smuggled consumer goods—financed by drug money probably amount to $400-500 million a year.* [redacted] 25X1

Colombian agriculture has significant potential for expansion and diversification. The World Bank recently granted $425 million in loans to strengthen the agricultural sector. Barco's integrated rural development program is aimed at increasing food production and alleviating rural unemployment. Insurgent activity, however, has hampered the past efforts to implement rural development projects and will pose obstacles to Barco's program. [redacted] 25X1

US commercial interests would benefit from a sustained economic recovery in Colombia—the third-largest US export market in Latin America. We foresee increased opportunities for US sales as a result of Bogota's import liberalization and improved foreign exchange situation, continuing the late 1985 upturn. Because of the need to diversify exports, the Barco government probably will criticize US countervailing duty actions on Colombian goods, including textiles and cut flowers. On the regional debt front, Bogota's willingness to adopt IMF-monitored policies and good macroeconomic management record could serve as a role model for other Latin American debtors. Nevertheless, guerrilla attacks on oil facilities and other economic targets will continue to discourage foreign investment, despite Barco's plans to attract new capital. [redacted] 25X1

[redacted] 25X1

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The Tunisian Economy: At an Impasse [redacted] 25X1

Tunisia's worsening economic situation is severely depressing the country's living standards and is adding to an already high level of political tension. The appointment of Rachid Sfar, former Minister of Economy and Finance, as Prime Minister, last month, along with other cabinet changes, indicates growing government awareness of the urgency of the problem. At the same time, however, fears that new austerity measures will prompt a repeat of the bloody January 1984 food riots have so far held President Bourguiba's government back from effectively addressing Tunisia's economic woes. These same fears will also probably hamper implementation of the government's structural adjustment program recently proposed to facilitate desperately needed foreign aid. Reduced consumer subsidies, minimal wage increases, and a hefty currency devaluation—all long-standing issues with Western donors—are almost certain to generate popular unrest. Nevertheless, Tunis is looking at a current account deficit that could exceed $1 billion this year, and, without some financial relief, will encounter severe problems in meeting even essential needs. [redacted]

The Economic Plight

Tunisia, like its North African neighbors, depends on oil for its economic well-being. The petroleum sector accounts for 40 percent of export receipts, 20 percent of government revenues, and 10 percent of GDP. As with other oil producers, the prolonged oil market slump has had a decidedly negative impact on Tunisia's domestic economy:

- Real GDP per capita—at $1,100, still among the highest in Africa—has sunk far below the oil-boom levels of the late 1970s.
- Inflation is running on an annual basis at almost 14 percent, while wages remain frozen at 1983 levels.
- The economic slowdown has pushed unemployment over 30 percent, and unemployment and underemployment together are as high as 50 to 60 percent in urban areas.
- Unemployment has hit the young hardest—70 percent of the populace is under the age of 26, and the population is growing at a rate of nearly 4 percent annually. [redacted] 25X1

Nevertheless, fears of popular backlash to the new austerity measures have held the Bourguiba government back from effectively addressing Tunisia's economic woes. Tunis had attempted in 1983 to begin to realign the economy and ease the country's financial bind by slashing consumer subsidies and imports, restricting development expenditures, and freezing wages. Local reaction to these measures was largely muted. In January 1984, however, the government misjudged public patience. Tunis removed subsidies on wheat—a staple of the Tunisian diet—causing bread prices to double and triggering nationwide riots. The disturbances were quieted only after the military was called in and Bourguiba reinstituted the subsidies. Wary of further backlash, the government has instituted few new reforms since. It has carefully avoided any politically sensitive reforms—such as devaluation—necessary to bring spending more in line with revenues and to broaden the economic base. 25X1
[redacted] 25X1

Last year, the poor performance in the petroleum sector was at least partially offset by surprisingly strong performances in both agriculture and tourism. This year, however, these sectors are in trouble. Inadequate rain is curtailing cereals production—producing sporadic shortages—and threatening herds. In addition, Tunisia's tourism industry is still feeling the effects of the Israeli raid on Tunis in October and continued Libyan terrorist threats. [redacted] 25X1

Other sources of revenue also are sluggish. World demand for raw phosphate remains depressed, because of oversupply and an industry shift toward using phosphoric acid and other processed derivatives. The

Tunisia: Balance of Payments, 1981-85 *Million US $*

	1981	1982	1983	1984	1985 [a]
Current account balance	−848	−938	−811	−1,044	−825
Trade balance	−1,324	−1,409	−1,257	−1,389	−1,195
Exports (f.o.b.)	2,454	1,979	1,860	1,793	1,665
Hydrocarbons	1,308	910	832	798	655
Agricultural products	238	181	143	178	200
Phosphates and chemicals	365	349	353	319	300
Other	544	539	532	497	510
Imports (c.i.f.)	3,778	3,388	3,116	3,182	2,860
Hydrocarbons	747	377	346	369	380
Industrial goods	2,021	2,082	1,728	1,824	1,635
Food	428	356	434	427	335
Consumer goods	583	573	608	561	510
Net services and transfers	476	471	446	345	370
Of which:					
Tourist receipts	590	575	562	449	490
Worker remittances	356	372	352	309	290
Capital account balance	654	735	582	549	525
Long-term capital	634	716	557	521	500
Direct investment	362	402	219	201	190
Medium- and long-term loans	272	314	338	320	310
Official grants	20	19	25	28	25
Basic balance	**−194**	**−203**	**−229**	**−495**	**−300**
Short-term capital	78	58	16	150	
Other (including errors and omissions)	62	215	174	184	97
Change in reserves	−54	70	−39	−161	−203

[a] Estimated.

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market for Tunisian phosphate rock is particularly grim, according to industry experts, because of its poorer quality. Worker remittances also are down, the result of a declining European market for foreign workers and Libya's August 1985 expulsion of 32,000 Tunisian workers.

Revenue shortfalls have forced Tunisia to nearly exhaust its foreign reserves. As a result, Tunis is looking for an immediate $150-200 million bilateral aid injection until it can secure funds from multilateral or commercial sources this fall. Along with requests to Washington for additional aid and debt relief, Tunis has approached other donors as well. Paris has been asked to provide an immediate 50,000 metric tons of grain, a $50 million loan to finance additional grain imports, and another $50 million long-term trade credit. Tunisia is also looking to Italy, Kuwait,

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Tunisia: Balance-of-Payments Scenarios, 1985-86 *Million US $*

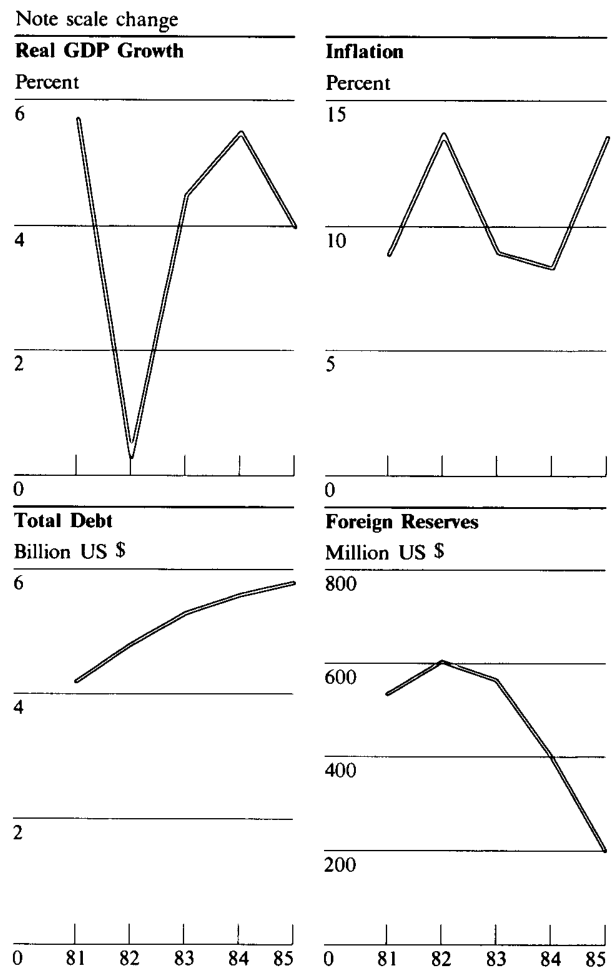
	1985	1986	
		$15 per barrel of oil	$10 per barrel of oil
Current account balance	−825	−1,032	−1,060
Trade balance	−1,195	−1,332	−1,360
Exports [a] [b] (f.o.b.)	1,665	1,168	1,078
Hydrocarbons	655	288	198
Agricultural products	200	100	100
Phosphates and chemicals	300	270	270
Other	510	510	510
Imports (c.i.f.)	2,860	2,500	2,438
Hydrocarbons	380	185 [c]	123 [c]
Industrial goods	1,635	1,575	1,575
Food	335	255	255
Consumer goods	510	485	485
Net services and transfers	370	300	300
Of which:			
Tourist receipts	490	280	280
Worker remittances	290	200	200
Capital account balance	525	390	390
Long-term capital	500	340	340
Direct investment	190	140	140
Medium- and long-term loans	310	200	200
Official grants	25	50	50
Basic balance	**−300**	**−642**	**−670**
Short-term capital		425	425
Euroloan		175	175
Multilateral		200	200
Bilateral		50	50
Reserve position	203	−14	−42

[a] Assumes crude oil production of 100,000 b/d and consumption of 51,000 b/d.
[b] Assumes $20 million in refined product exports.
[c] Assumes refined product imports of 11.9 million barrels at a cost of $15.60 per barrel and $10.40 per barrel, respectively.

[redacted]

and Saudi Arabia for help. Paris, and possibly Italy and Saudi Arabia, are likely to support US efforts to tie any major increase in aid commitments to an IMF agreement. [redacted] 25X1

Tunisia: Economic Indicators,1981-85



[redacted] 25X1

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[redacted] the effect of the deteriorating economy and growing joblessness is currently being felt most acutely in the south where antigovernment sentiment has traditionally been strong. Government officials there cite widespread 25X1 25X1 malnutrition and unprecedented crime levels. Disgruntlement with economic conditions, in general, has already led to several localized demonstrations against the government. Many of the towns are the same ones involved in the January 1984 disturbances, which quickly spread north to impoverished urban areas. [redacted]

Looking Ahead

The continuing slump in world oil prices, along with poor performances in nearly every other sector of the economy, presages a very difficult year. Economic growth could well be negative—as much as 3 percent—for the first time in over two decades. Tunis also faces a sixth straight year of current account deficits; this year's shortfall could surpass the 1984 record of slightly more than $1 billion. [redacted]

After months of ignoring mounting pressure from aid donors for action, the Bourguiba government is finally beginning to confront the country's accelerating economic difficulties. According to Embassy reporting, Tunisia decided in June to implement a six-year structural adjustment program in conformity with reforms long advocated by the World Bank and other Western donors. The program will reportedly emphasize demand restraint and export promotion. Adjustments slated for this year include price increases in basic commodities such as milk, sugar, corn, soybean meal, bread, pasta, and cooking oil, no wage increases except the minimum wage, about $250 million in budget and development spending cuts, modifications of price and import controls, and a free float of the Tunisian dinar, which is expected to result in an effective devaluation of 11 to 14 percent. Government changes announced in July, which elevated the former Minister of Economy and Finance, Sfar, to Prime Minister and promoted the architect of Tunisia's adjustment plan, former Minister of Planning Khelil, to Minister of Economy, Finance, and Planning underscore the government's new resolve. [redacted]

The structural adjustment program as presently written would significantly ease Tunisia's economic difficulties over the long run. Reduced government subsidies on food, development spending cuts, and continued wage restraints, for example, hit three major sources of budgetary deficits. Altering the country's exchange rate should also make Tunisian nonoil exports more competitive and help keep a lid on import demand. Moreover, an adjusted dinar along with reduced import controls and revised tariff and customs duties will eventually help promote new exports, broadening Tunisia's economic base and making the economy less susceptible to the vagaries of the world oil market. [redacted]

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We also believe, however, that many of the proposed reforms could easily spawn domestic unrest long before the program churns out any benefits. A particularly explosive element in the government plan is the hard line on wages combined with gradual cuts in most food subsidies. The decline in purchasing power would be even more sizable if accompanied by the proposed devaluation. Reduced development expenditures could also touch off unrest as project cancellations cause layoffs or firings at a time when unemployment is already at record levels. [redacted]

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As a result, we believe that backstepping from this year's goals or, at the very least, a stretching-out of the reform timetable is likely. In our opinion, the 1984 riots are seared into the collective memory of the Bourguiba government, and those memories will temper any zeal for reform. At the same time, Tunis cannot abandon the adjustment package entirely for fear of losing promised international aid. For example, Tunis's proposed program probably was behind the World Bank's recent decision to provide some $180 million in agricultural and industrial development loans. The Bank is also considering loans in the public enterprise and housing sectors. Embassy sources claim that Tunis may use its structural adjustment program as collateral to draw on automatically available IMF funds and other multilateral aid sources for another $160 million. These amounts are in addition to a $175 million Euroloan secured earlier this year. [redacted]

[redacted]

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Key LDC Debtors: Grappling With Capital Flight [1]

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Capital flight, which we estimate has bled nearly $180 billion from the key LDC debtors over the past decade, remains an obstacle to the solution of their international financial problems. The debtors are having a harder time balancing their international accounts because high borrowing requirements—due in part to continuing capital flight—are running up against creditors' resistance to new lending. In addition, lenders are using the capital flight issue to justify further lending cutbacks. Unless the debtors implement structural reform, which would remove the powerful incentives for capital outflows, we believe their financial straits will persist, multiplying economic problems and undermining political stability.

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The Rise and Fall of Capital Flight

According to our estimates, the flight of capital from the key LDC debtors had accelerated dramatically before the international financial crisis began in 1982. Capital flight reached a peak of $31 billion in 1981—up from $9 billion in 1976. The $86 billion that left these countries during 1980-82 is equivalent to 52 percent of their net foreign borrowing, 12 percent of their gross fixed investment, and nearly 3 percent of aggregate GDP. Mexico, Argentina, and Venezuela were the hardest hit during this period, while Brazil was virtually untouched by capital flight.

The unprecedented flight of capital from the key LDC debtors during 1980-82 can be traced primarily to economic mismanagement:

- We believe ***overvalued exchange rates*** were the key cause of this capital exodus. When currency devaluations failed to keep pace with inflation, the debtors' real exchange rates appreciated by over 30 percent during 1978-81. Overvalued exchange rates made foreign assets cheaper and raised the specter of large devaluations.

- ***Negative returns on domestic assets*** were also an important cause of capital flight. Real interest rates grew increasingly negative as governments fixed nominal interest rates below the rising rate of inflation.

- ***Heightened uncertainty*** over imminent economic adjustment made assessing the returns and risks of domestic assets difficult. There also was increased political uncertainty arising from martial law, military coups, rising political opposition, and transitions to civilian rule.

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Estimating Capital Flight

We define capital flight as the net accumulation of foreign assets by private citizens. This accumulation is the natural reaction of residents, who are trying to preserve or increase their wealth, to prevailing economic and political conditions. Capital flight cannot be measured directly or accurately because of its often surreptitious nature. However, crude estimates can be made using balance-of-payments and debt data. We use the "implicit capital outflow" method, which estimates capital flight as a residual. Our estimate equals net foreign direct investment plus net foreign borrowing minus the change in nongold reserves plus the current account balance. Because of the many shortcomings of this method, our estimates should not be viewed as point estimates, but rather as benchmarks representing the minimum level of capital flight.

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[1] The key LDC debtors include Argentina, Brazil, Chile, Mexico, Nigeria, Peru, the Philippines, and Venezuela. Dollar values are measured in 1985 US dollars, and growth rates were calculated from constant-dollar values.

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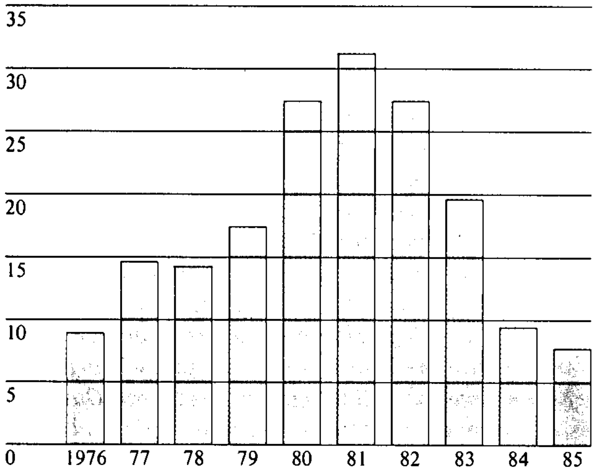
Key LDC Debtors: Capital Flight, 1976-85

Billion 1985 US $



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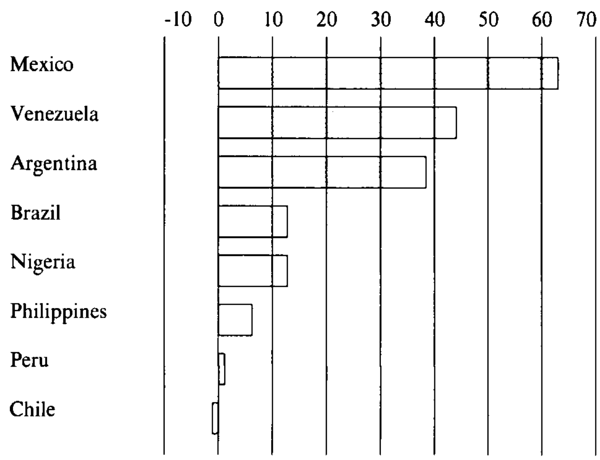
Key LDC Debtors: Capital Flight by Country, 1976-85

Billion 1985 US $



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Although our estimates indicate that outflows have tapered off since the international financial crisis began, capital flight continued to plague the key LDC debtors. As massive capital outflows from Mexico and Argentina were partially staunched, capital flight fell from $31 billion in 1981 to less than $8 billion in 1985. We believe, however, this capital loss inflicted more damage than past episodes of capital flight because of the severe foreign exchange shortage during the period. The $37 billion that left during 1983-85 was equivalent to nearly 75 percent of net foreign borrowing. We also believe capital flight may have been even higher because, with tighter capital controls, outflows that once were easily measured were pushed underground and became impossible to detect.

We believe a combination of new foreign exchange policies and economic austerity reduced capital outflows from the key LDC debtors:

- The most important step taken to limit capital flight was the move to ***more realistic exchange rates***. Faced with financial crisis, these countries devalued their currencies by 40 percent in real terms during 1982-85, pushing up the domestic currency cost of foreign assets.

- A ***drop in savings***—the funds available to finance foreign asset purchases—also stifled capital flight. Forced economic austerity in the key LDC debtors led to a 13-percent contraction in the pool of savings during 1983-85. Resident saving was stagnant, and savings from foreign sources plummeted when foreign borrowing was curtailed.

Key LDC Debtors: Annual Average Capital Flight, 1976-85 *Billion 1985 US $*

	1976-79	1980-82	1983-85	**1976-85**
Total	**13.8**	**28.7**	**12.2**	**17.8**
Argentina	3.1	8.7	0.1	**3.8**
Brazil	2.3	0.1	1.1	**1.3**
Chile	−0.3	0.2	−0.1	**−0.1**
Mexico	3.6	10.6	5.7	**6.3**
Nigeria	0	2.2	2.0	**1.3**
Peru	0.3	−0.4	0.4	**0.1**
Philippines	1.0	1.5	−0.7	**0.6**
Venezuela	3.9	5.8	3.7	**4.4**

- Most debtors also implemented ***stringent capital controls*** in hopes of buying time so the lingering problems of negative real interest rates and heightened uncertainty could be addressed. 25X1

The Mechanics of Capital Flight

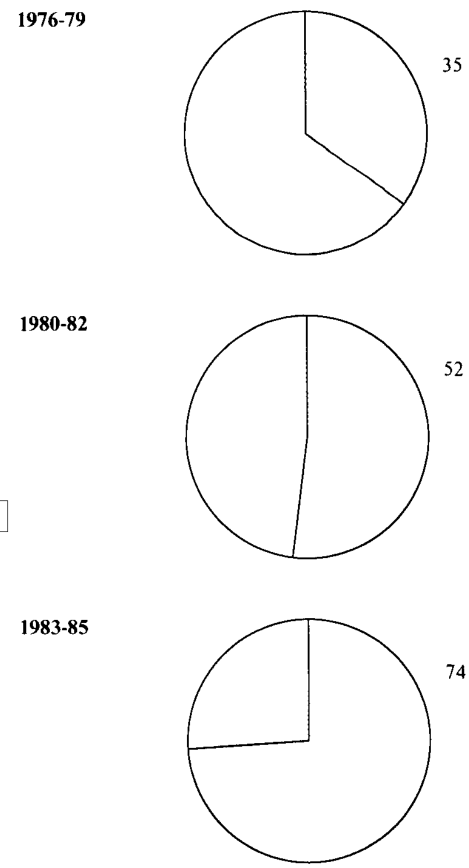
The mechanics of capital flight illustrate why the key LDC debtors have had difficulty halting capital outflows. Our analysis indicates that nearly all segments of society acquired foreign assets:

- ***Government officials*** were implicated in the most flagrant cases of capital flight. Per capita, they probably acquired more foreign assets than any other group. Corrupt chief executives were the premier capital flight artists, but cabinet ministers and bureaucrats also funneled illegal payments overseas.

- In fact, the ***business community***, including prominent businessmen, small businessmen, and multinational corporations, probably moved the most capital abroad. Their decisions to convert domestic profits to foreign assets were based almost exclusively on economic fundamentals.

Key LDC Debtors: Capital Flight as a Share of Net Foreign Borrowing

Percent



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- The ***general public*** also participated in a small way in the foreign asset rush. Even the unsophisticated learned the benefits of holding foreign assets. Residents often held US dollars "in the mattress." The general populace also acquired assets overseas through banking channels or by carrying small amounts of capital abroad. 25X1

We believe most of the capital that left key LDC debtors before the financial crisis moved overtly through legitimate channels. Unless the funds were tainted, there was no need to develop complicated schemes when capital controls were weak. In most cases, residents made deposits in local banks, and the funds were transferred by wire to accounts overseas. Capital was also physically carried out of the country. Residents mailed bank drafts overseas for deposit in foreign accounts or brought bundles of cash with them on foreign trips. [redacted]

As capital controls tightened, residents developed increasingly elaborate schemes to transfer funds abroad:

- The least elaborate ploys involve smuggling. [redacted] everything from cattle to Krugerrands is smuggled, but financial assets—cash, bonds, bank drafts, and traveler's checks—are the preferred cargo. Contraband is then converted to hard currency and the proceeds invested.

- More elaborate schemes to move funds abroad involve misreporting. Exporters underinvoice shipments and remit to the central bank only a portion of foreign exchange earnings. Importers overinvoice purchases and draw extra foreign exchange from the central bank.

- Clever residents also concocted more exotic ploys. They developed schemes to acquire readily convertible assets, such as gold, foreign exchange, or even airline tickets, for shipment overseas. Citizens also devised ways to hide their capital transfers through legitimate banking and commercial channels. Residents engage in parallel transactions such as currency swaps that enable them to acquire foreign assets without actually transferring funds across the border. [redacted]

Analysis of press and diplomatic reporting indicates that residents of the key LDC debtors invested their flight capital in an array of assets around the world. We believe about three-fourths of this capital ended up in developed countries. The United States was the largest recipient, with Switzerland a distant second, [redacted] Funds were also moved offshore to Panama, Hong Kong, and smaller havens such as the Cayman Islands and the Bahamas. A small amount flowed to nearby LDCs. Once capital was shifted abroad, we estimate that residents invested about two-thirds of it in financial assets and the rest in personal and business property. [redacted] 25X1 25X1

Fallout From Capital Flight 25X1

Although individuals benefited, we believe capital flight has had serious economic effects on the debtor countries:

- ***Higher foreign debt*** is the principal legacy. As capital streamed out of these countries, governments borrowed abroad to replace it. This policy set off a capital-flight foreign-borrowing spiral that was probably responsible for about one-half the buildup in their foreign debt during the past decade. 25X1 25X1

- Capital flight also reduced real income, leading to a ***lower standard of living*** for most citizens. As capital left the country, the pool of funds available for investment contracted, and domestic capital formation dropped off. This investment slump in turn reduced the countries' potential to produce goods and services.

- Capital flight also ***increased income inequality***. Those who acquired foreign assets, mostly the wealthy, received special benefits. Their foreign asset purchases were subsidized through overvalued exchange rates. Moreover, they purchased foreign assets paying high returns while others had to settle for at best the low returns available domestically. [redacted] 25X1

Assessing the political fallout from capital flight is difficult, but logic and anecdotal information suggest that capital flight has affected the political environment in these countries. As residents moved their capital abroad, their national allegiance was eroded because they had less personal stake in their coun- 25X1 tries' future. Capital flight also provided ammunition for the opposition, who used the issue to embarrass political leaders and undermine government support. Moreover, when capital flight made economic inequities more pronounced, some residents may have been attracted to leftist ideologies promising income equality.

Looking Ahead

While the exodus of capital from the key LDC debtors has slowed, we believe capital flight remains a major obstacle to the solution of their international financial problems. Capital outflows are keeping foreign borrowing requirements high at a time when access to foreign credit is severely limited. With foreign exchange scarce, capital flight is inflicting more damage on their balance of payments than ever before. Lenders are also seizing on capital flight to justify further lending cuts. They point to the fact that over 70 percent of the funds borrowed abroad since 1982 were used to acquire foreign assets—up from about 50 percent during 1980-82.

Our analysis indicates that structural reform, rather than tighter capital controls, would slow the exodus of funds by removing the incentive for capital flight. Historically, these countries have relied on capital controls to limit capital flight, but controls have been only partially effective. Well-connected elites operate above the law, and even the less powerful employ numerous methods to acquire foreign assets illegally. In contrast, more realistic exchange rates raise the cost of foreign assets. Financial market deregulation makes domestic assets more attractive by raising real returns. Consistent economic policies and strong democratic institutions reduce the risk of holding domestic assets.

If the key LDC debtors can overcome the obstacles to structural reform, repatriation of foreign assets accumulated by their residents may hold a key to the solution of their international financial problems. We believe residents own a stock of foreign assets equal to at least one-half the foreign debt of these countries. The debtors might entice some of this capital back if they adopted structural reform. Repatriated capital would help relieve balance-of-payments pressures and cut foreign borrowing requirements. Even if residents kept their foreign assets but repatriated earnings, the impact on international accounts would be significant. 25X1

If the obstacles prove insurmountable and the key LDC debtors fail to adopt structural reform, we believe capital outflows will remain stubbornly high and international financial problems will continue to dog these countries. They will have a harder time balancing their international accounts when inflated foreign borrowing requirements bump up against creditors' increased resistance to new lending. Forced to trim their international outlays, they probably would lobby even harder for debt service relief rather than institute greater import cuts. If concessions are not granted by creditors, more debtors might suspend principal repayments and limit interest payments.

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Syria: Limited Help From Domestic Oil Gains

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Oil from Syria's new Thayyem field will only marginally strengthen Syria's economy but will make Damascus less dependent on Iran for concessional oil shipments. The new field will begin producing 50,000 to 60,000 b/d in September when a new pipeline is completed and is expected to produce 100,000 b/d by 1988. Initially, this will reduce Syria's dependence on imported oil by about 40 percent. A stronger domestic oil industry will barely put a dent in Syria's profound economic problems, which result from years of misdirected Ba'thist policies and burdensome military spending. Syria will continue to run a large current account deficit and suffer chronic foreign exchange shortages, which will add to President Assad's political problems.

Syria: Crude Oil Industry, 1985 *Thousand b/d*

	Amount
Crude production	185
Refinery capacity	210
Light crude	140
Heavy crude	70
Total exports	120
Heavy crude	100
Products	20
Product consumption	190

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Oil Trade Deficit

Although crude oil and products account for over 60 percent of exports, Syria is a net importer of oil. Syrian refineries are designed to operate on a blend of domestic heavy crude and imported light crude but operate more efficiently on straight light crude. According to the US Embassy, the Syrian oil trade deficit was about $200 million in 1984 and probably larger in 1985, mainly as a result of the declining volume of crude exports.

Exports are depressed because of lower prices and stagnant production. Revenues from oil exports fell from over $1.3 billion in 1980 to less than $900 million in 1985. The official price for Syrian crude was steady through 1985 but fell dramatically in February after Damascus reluctantly introduced "netback" pricing, which ties the crude sales price to the value of refined product. The fall in exports has been aggravated by erratic Iranian deliveries. Exports fell in 1985 by at least 20,000 b/d as the Syrians were forced to divert export oil for domestic use. If the increase in Thayyem production is unexpectedly delayed until 1987, we estimate this year's exports of crude could provide less than $400 million.

Imports of crude oil and products represent a growing share of Damascus' hard currency imports. Syria's primary supplier, Iran, has pressed Damascus for prompt payment and often suspended deliveries. According to press reports, periodic cutoffs this year have forced purchases of 50,000 b/d of light crude on the Mediterranean spot market. These purchases have almost exhausted Syrian foreign exchange reserves and probably underscored for Assad his growing economic isolation.

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Growing Energy Imbalance

Although Damascus has granted several exploration and drilling concessions to foreign firms since 1974, these firms failed to find any major new fields until the recent Thayyem discovery. After peaking in 1976 at 200,000 b/d, current Syrian oil production has slipped to 185,000 b/d,

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Iran: Syria's Import Lifeline

Syria's oil import requirement, combined with its chronic low foreign exchange reserves—estimated at less than $100 million in May—makes it dependent on concessional oil shipments. Since Damascus broke relations with Iraq in 1982 and closed the 1.2-million-b/d Kirkuk-Hims pipeline, Syria has relied primarily on Iran for crude oil deliveries to meet its growing demand. [redacted] 25X1

Syrian nonpayment of its debt and Iranian intransigence on additional price concessions have strained relations and resulted in periodic cutoffs of Iranian deliveries. Last year's oil imports from Iran totaled less than 75 percent of the contract amount [redacted] 25X1 [redacted] *Moreover, Syrian tankers loaded with Iranian oil have been targets of Iraqi attacks twice in 1986, further disrupting crucial imports. We estimate 1986 deliveries of Iranian oil at approximately 6.5 million barrels. The oil link to Iran has been weak since the outset of the relationship in 1982. Deliveries have continued, albeit at progressively lower levels, despite Syria's consistently poor payment record.* [redacted] 25X1

Domestic consumption of petroleum products has doubled since 1975. We estimate current demand for petroleum products is 150,000 to 190,000 b/d and growing more than 10 percent annually. Military and industrial demand as well as price subsidies have fostered high consumption of several products. Syria is only partly meeting current domestic demand for oil products. The government in late 1985 announced much-needed price increases for most petroleum products to curb demand and reflect actual costs. According to Embassy reporting, rationing of some oil products began in February, and electricity is shut off in Damascus for three or more hours per day. [redacted] 25X1

The Pecten Syria Corporation—a consortium of Shell USA, Royal Dutch Shell, and Deminex of West Germany—is developing Thayyem and other finds and will divide the marketed production with the Syrian Government. According to Embassy reporting, production from the Thayyem field in eastern Syria will increase to 50,000 to 60,000 b/d by September, and Pecten officials have promised Assad 100,000 b/d by 1988. [redacted] we expect production goals will be met on schedule. We estimate the low-gravity, low-sulfur Thayyem crude will reduce imports by about 40 percent over the next year. [redacted] 25X1 25X1

Financial Gains Fall Short

[redacted] 25X1 25X1 25X1

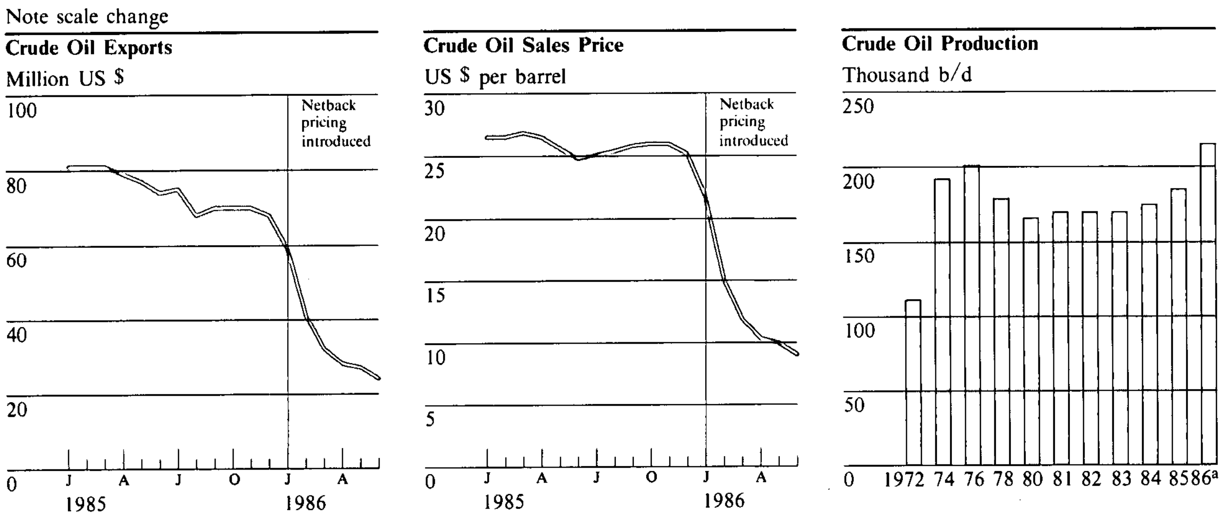
[redacted] 25X1

Because Damascus has exercised its option to use the lighter Thayyem crude domestically, total oil exports may actually fall as Syria compensates Pecten with heavier Suwaydiyah crude on a value equivalent basis. While the current market prices for the two grades of crude are very close, light grades generally are higher priced. Pecten's share could increase by up to 20 percent when prices rebound, cutting further into Syria's return. [redacted] 25X1 25X1

Long-Term Growth Potential

Syria will probably remain a net importer at least until 1988. We estimate Pecten output will have to increase to over 75,000 b/d—including Syria's foreign partners' share—before Syrian oil trade comes

Syria: The Oil Industry



[a] Estimated.

[redacted] 25X1

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into balance. After production exceeds 75,000 b/d, Syria and its partners will export part of the Thayyem crude [redacted] After the cost recovery period of at least two years, Syrian export earnings on 75,000 b/d (at $15 per barrel) would increase by about $100 million but still leave Syria with an estimated $2 billion current account deficit. [redacted]

Embassy reports on estimated reserves suggest Syria may become self-sufficient in crude oil and perhaps a net crude oil exporter in the next decade. Pecten has found oil in a third concession east of Thayyem that may allow substantially higher production by the early 1990s. [redacted] Pecten's extensive investment and planned excess capacity suggest higher long-term production is a realistic possibility. [redacted]

Syria still has high reserves in its northeastern fields, and production could be maintained and even increased if Syria invested more in advanced Western equipment and seismic studies. The Syrian Petroleum Company, however, has relied on outmoded equipment and technical support, mostly Soviet, to operate its principal fields at Suwaydiyah and Qaratshuk, and it is unlikely Damascus would allow greater Western involvement in its oil industry at this time. [redacted]

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Outlook and Implications

For the next year or two, Damascus will remain dependent on its present suppliers, especially Iran, for concessional oil shipments. Syrian import needs over the near term are confirmed by the oil supply contract recently negotiated with Tehran for 100,000 b/d through March 1987. As Thayyem production is

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[redacted]

stepped up during 1987 and other finds are developed, Damascus will gradually grow less dependent on foreign suppliers and Assad will have more room to maneuver. [redacted] 25X1

Syria's foreign payments position will probably remain troubled, even as oil trade moves into surplus. Nonoil exports are weak and declining, and foreign aid will probably continue to contract as the economic slowdown in the region continues. Assad may be inclined to take measures to increase Syria's share of the increased output from the new oilfields. If relations with Pecten in particular, or the United States in general, turn sour, Syria may well increase taxation on its foreign partners, demand renegotiation of the production-sharing contract, or even expropriate foreign assets. [redacted] 25X1

The prospects for increased US leverage over Damascus through greater involvement in the oil industry are poor. Although Pecten has a high stake in Syria, threats of sanctions and disinvestment are not likely to induce Assad to alter his policies. If Pecten withdrew operations in Syria, the impact on Damascus would be minimal. The Syrian Petroleum Company—possibly with Soviet, East European, or Arab assistance—could easily take over Pecten's operations with little disruption. In addition, West European oil firms, including Pecten's part owners Royal Dutch Shell or Deminex, could offer Western expertise to keep production on schedule and continue exploration on new fields. [redacted] 25X1

[redacted] 25X1

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Briefs

Energy

OPEC Production Update

OPEC crude oil production averaged 20.2 million b/d in July, an increase of 1.2 million b/d from June levels. This increase came primarily from Saudi Arabia, which extended its netback discounts through September and aggressively marketed its oil to boost output by 600,000 b/d. Kuwait's output rebounded by 400,000 b/d as it was able to resume normal operations after the sabotage of its oil facilities in mid-June. Similarly, Iran increased output to 2.2 million b/d after June's supply disruption. Only Libya saw its production fall slightly—by 100,000 b/d. US oil companies stopped liftings on 30 June—withdrawing 250,000 b/d from the market—but Libya was able to find new customers to offset part of this loss. 25X1

OPEC Oil Production, 1986 *Million b/d*

	First Quarter	Second Quarter	June	July
Total	**17.8**	**18.6**	**19.0**	**20.2**
Algeria	0.7	0.7	0.7	0.7
Ecuador	0.3	0.3	0.3	0.3
Gabon	0.2	0.2	0.2	0.2
Indonesia	1.3	1.3	1.4	1.4
Iran	2.3	2.2	2.0	2.2
Iraq	1.8	1.8	1.8	1.8
Kuwait [a]	1.3 (1.2)	1.5 (1.2)	1.2 (1.0)	1.6 (1.5)
Libya	1.0	1.1	1.2	1.1
Nigeria	1.4	1.6	1.5	1.5
Qatar	0.3	0.3	0.3	0.3
Saudia Arabia [a]	4.4 (4.3)	4.8 (4.7)	5.4 (5.3)	6.0 (5.8)
UAE	1.2	1.4	1.5	1.5
Venezuela	1.6	1.6	1.6	1.6

[a] Amount in parentheses excludes production from the Neutral Zone, whose output is divided between Saudi Arabia and Kuwait and included in their country quotas; the Neutral Zone has no production quota of its own.

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Spot Oil Price Developments

Spot oil prices have risen as much as $5 per barrel this week in response to the OPEC decision to cut current production by 3.5 million b/d in September and October. Key North Sea and US crudes are selling for $14.30 and $15.00 per barrel, respectively, compared to $9.30 and $11.05 last week. Prices remained low during the OPEC meeting, reflecting traders' skepticism that OPEC oil ministers would be able to reach a formal agreement to reduce supply. There is still considerable doubt that OPEC discipline has been restored, and prices will quickly fall if the market perceives that OPEC members are cheating on their new quotas. [redacted] 25X1

[redacted]

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Japan and Indonesia Reach LNG Price Agreement

Tokyo has agreed to pay above-market prices on a month-to-month basis for Indonesian liquefied natural gas (LNG) in exchange for future compensation. Jakarta has offered LNG for export to Japan in August for about $2.59 per million Btu (MMBtu)—equivalent to a crude oil price of $16.50 per barrel. Under a 1981 contract linking LNG prices to the official selling price of a basket of Indonesian crudes, LNG revenues have plummeted. [redacted] 25X1

Japan is looking to Indonesia as a long-term supplier and is thus more willing to accept these higher prices for the immediate future. [redacted] 25X1

International Finance

[redacted]

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Ecuador's IMF Agreement in Jeopardy

The US Embassy reports the IMF has delayed action on Ecuador's request for $138 million in loans because of Quito's failure to implement economic reform measures, particularly a devaluation. Ecuador needs the loans to meet a projected foreign payments deficit of $750 million this year caused by declining oil revenues. Moreover, IMF approval of the loans is required both to trigger the second disbursement of a US bridge loan needed to sustain foreign exchange reserves and to lead to a rescheduling of Ecuador's official debt by the Paris Club. Although some accommodation with the Fund will probably be reached before the IMF Board meets again at the end of this month, the delay will cause political problems for President Febres-Cordero. He cannot appear to give in to IMF pressure, yet he must take action on the faltering economy. The new leftist-controlled Congress opens on Sunday, and it will be ready to exploit the President's recent economic setbacks. 25X1

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Sudanese Legal Actions Against Banking Community

Sudanese officials appear intent on prosecuting foreign and Islamic bank managers for alleged illegal credit and foreign exchange operations. To date, one manager has been arrested, another has fled the country, and fines of $24 million have been levied. The banks whose "gray" foreign exchange transactions were until now widespread and tolerated reportedly have been targeted by leftist elements within the government intent on discrediting the banking sector. More prosecutions and fines may cause several foreign branch banks to close operations in Khartoum, disrupting already strained credit and trade lines and further damaging Sudan's reputation within the international financial community. 25X1

International Trade

Agreement Reached on MFA

The GATT Textile Committee on 1 August reached a tentative agreement renewing the Multifiber Arrangement (MFA) after 48 hours of intense negotiations. The agreement must still be ratified by the GATT member governments. Significant changes from the previous MFA include coverage for linen, ramie, silk, and several other fibers, and the authorization to continue unilateral measures to halt import surges for an additional year if the respective trading partner is unwilling to negotiate. The accord is more restrictive than the LDCs wanted. Throughout the negotiations, LDCs sought better terms for cotton and wool suppliers, tighter market disruption criteria, and speedier dispute handling. LDC efforts to obtain commitments to liberalize textile trade or phase out the MFA were also unsuccessful. LDC discontent with the MFA could make talks for the new trade round more difficult and give hardline LDCs, such as Brazil, greater support. 25X1

Global and Regional Developments

Japan Preparing South African Economic Sanctions

The Japanese Foreign Ministry told US Embassy officials last week that Tokyo is willing to impose harsh economic sanctions against South Africa if the United States and the United Kingdom take similar action. Tokyo has already drafted a set of measures, including a ban on imports of coal, iron ore, and agricultural products. Other moves under consideration include banning flights to and from South Africa, barring South African tourists from visiting Japan, and discouraging Japanese citizens from vacationing in South Africa. Japan, which has been criticized for not being more active in the international arena, probably believes that the United States and the United Kingdom will soon take strong measures. It does not want to appear reluctant to participate. The proposed sanctions would cut Japan's purchases from South Africa in half. Past sanctions, which included a longstanding ban on direct investment in South Africa and limits on computer exports, have not significantly affected the volume of trade. 25X1

Foreign Aerospace Plane Development Programs

Western Europe and Japan are debating development of completely reusable space launch systems. The United Kingdom is proposing HOTOL, a horizontal-take-off-and-landing launcher, which would use a combination of air-breathing and rocket propulsion. The British contend that HOTOL would lower launch costs by 50 percent for geostationary orbit and 80 percent for low-Earth orbit. Recognizing they could never fund the projected $6 billion development alone, Britain is attempting to compete with Hermes—the French-proposed, rocket-launched, spaceplane—for European Space Agency support. The West German Research Ministry is also considering HOTOL participation. In addition, the West Germans are developing the Saenger, a two-stage spaceplane with a recoverable air-breathing booster. For their part, the Japanese are exploring technologies for an advanced air-breathing hypersonic engine, but have not committed to a development program. Although none of the foreign efforts are as far advanced as those of the United States, there may be an opportunity for cooperation to speed the technology development and lower US development costs. [redacted] 25X1

Brazil-Iraq Countertrade Deal Stalls

Brazil has suspended its $630 million countertrade deal with Iraq—signed in December 1984—under which 100,000 Brazilian Volkswagens were to be bartered over 25 months for Iraqi oil. Rio de Janeiro blames domestic labor problems for the action, but it is almost certain that falling oil prices were responsible. Brazil agreed to accept a quantity of oil determined by the spot market price of $27 per barrel at the time the contract was signed—and to absorb all transport and storage costs. With oil prices declining to about $8 per barrel, Brazil faced substantial losses on the deal even though Iraq raised the monthly amount of oil shipped. [redacted] 25X1

Latin American Regional Integration Efforts Accelerate

The recent Argentine-Brazilian bilateral economic cooperation agreement will further stimulate efforts toward Latin American economic integration, [redacted] 25X1 Uruguay has already been invited to join the agreement [redacted] 25X1 Also, Buenos Aires 25X1 and Brasilia want Mexico and Venezuela included. We believe that Montevideo might announce its formal participation in the Argentine-Brazilian system as early as next week, during President Sanguinetti's visit to Brazil. Other countries, such as Mexico and Venezuela, are likely to be more cautious. Despite these positive steps, economic integration almost certainly will be a slow process, given the historical suspicions among Latin American countries and the inherent difficulties in implementing economic cooperation schemes. [redacted] 25X1

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National Developments

Developed Countries

Weak Canadian Dollar Worries Ottawa

Ministry of Finance officials are worried that any attempt to boost the slowing Canadian economy could cause another currency crisis. With recent forecasts showing the economy growing only 2.5 to 3 percent in 1986—almost a full point below Ottawa's February estimate—the government would like to lower interest rates. Recent efforts to reduce the gap between the US and Canadian discount rates, however, have caused sharp drops in the Canadian dollar, forcing the monetary authorities to quickly widen the differential. Ironically, part of the currency's weakness probably stems from Ottawa's budget reduction measures: the recent boost in sales taxes helped keep inflation close to 4 percent while rates in the rest of the major industrial countries have declined. Canadian officials also fear that the initial impact of a pickup in US economic growth would be higher interest rates, which would force them to either match the rate increases—slowing the economy further—or accept a weaker currency. 25X1

Canadian Auto Import Policy Creating Problems

Ottawa has decided not to press South Korea for "voluntary" auto export restraints—while attempting to retain such limits on Japan. [redacted] The decision is sure to anger Tokyo, because Ottawa is demanding that Japan allow only a slight increase in auto exports despite substantial investments in Canada made by Japanese carmakers in the past year. Moreover, Ottawa is likely to further aggravate the situation by supporting Suzuki's request that Tokyo grant it the majority of the eventual increase in the Japanese quota. Suzuki claims that it must increase its visibility in Canada in order to ensure the success of its proposed joint venture with GM to build a plant in Ontario. [redacted] 25X1

Spanish Industrial Restructuring Extended

Poor market prospects for traditional industries, increased competition from other EC steel producers, and promises to the EC to cut back steel capacity probably are the major factors that have prompted Madrid to extend an industrial restructuring program. The program—originally expected to cost $6.7 billion during 1984-86—aimed at enhancing export competitiveness and bolstering the finances of sunset industries by trimming surplus labor, closing inefficient plants, and modernizing production. According to press reports, Madrid believes that further gains are necessary, and it intends to spend an additional $1 billion during 1987-88 to support investments in equipment, restructure debts, and lay off additional workers. We expect most of this effort will be directed at the steel and shipbuilding sectors. Madrid must reduce crude steel capacity by 3 million tons under the terms of its EC accession agreement, and Spanish steel firms are demanding that the government finance layoffs of another 10,000 to 20,000 workers. Worldwide surplus capacity and slack demand will probably lead to sharp cuts in shipyard capacity and employment. [redacted] 25X1

Greek Parliament Passes VAT Legislation

The Greek Parliament last month fulfilled a longstanding commitment to the EC by imposing a value-added tax (VAT) effective 1 January 1987. Athens previously had requested three delays, but finally committed itself to implementing the tax as part of a deal to receive a $1.5 billion balance-of-payments loan from the EC last November. The VAT will replace 10 of 24 existing indirect taxes. It will have three rates—averaging about 10 percent—and will cover all goods and services except banking and insurance; banking services will become taxable in 1989. Athens probably hopes that the VAT, coupled with the tougher enforcement measures adopted earlier this year, will reduce widespread tax evasion and help decrease the budget deficit, which hit a record last year. Government estimates indicate, however, that the tax will raise only about $3 billion—or approximately the same amount that would have been raised by the indirect taxes that are being abolished. [redacted] 25X1

Turkish Prime Minister Visits the USSR

The main result of Prime Minister Ozal's recent trip to Moscow was the signing of agreements on tourism and economic planning. Ozal did not meet with General Secretary Gorbachev, however, and the two sides failed to resolve their disagreements over the Soviet ban on turbot fishing in its economic zone in the Black Sea and the Soviet FIR line, which the Soviets claim extends to Turkey's shores. The only surprise was an agreement on the repair of Soviet commercial ships in Turkish ports. The two sides also discussed Turkey's purchase of Soviet natural gas, 70 percent of which will be paid for by Turkish exports. If the Turks are unable to sell this amount, then Turkish contractors will be offered opportunities to build hotels in the Black Sea region in the Soviet Union as payment. 25X1

Israeli Shekel Linked to New Foreign Currency Basket

The shekel is now pegged to a five-nation foreign currency basket, according to an announcement by the Bank of Israel last week. This ends the informal policy that had pegged the shekel to the dollar since the start of the economic stabilization program in July 1985. The new basket is composed of a weighted average of the currencies of Israel's principal trading partners: the US dollar will make up 60 percent; the West German mark, 20 percent; the pound, 10 percent; and the French franc and yen, 5 percent each. The Bank of Israel stressed that this is a technical measure and that there was no intention of effectively devaluing the shekel. Bank officials hope the move will help bring inflation in Israel down to European levels while minimizing the shekel's fluctuations against the newly incorporated currencies. 25X1

Less Developed Countries

Mexican IMF Agreement Brings Respite

Mexico's new IMF program will provide $1.5 billion over 18 months and contains unprecendented contingency measures to increase financing if oil prices fall or the economy does not rebound sufficiently. The agreement also features relatively lenient economic targets consistent with Mexico's planned growth of 3 to 4 percent next year. For example, the IMF negotiators backed off their original demand that Mexico's deficit as a share of GDP be held at about 6 percent this year, and agreed to a target of 16.9 percent. We believe that most Mexican policymakers are convinced that they received a good deal and will make a stronger effort than in the past to adhere to the agreement. 25X1

Reactions to Brazilian Economic Adjustments

President Sarney retains basic support for his Cruzado Plan, but has received considerable criticism for the adjustments he recently made to the program. [redacted] mixed reaction to the compulsory saving program—heavy surcharges on automobiles, fuel, foreign travel, and the purchase of dollars on the parallel market—announced on 23 July. Leaders of the governing coalition publicly supported the effort to restrain consumption, but have criticized the lack of prior consultation. The leftist parties and labor have charged that the new taxes represent a lifting of the price freeze, [redacted] Several prominent business leaders complained that the private sector is bearing the cost of the battle against inflation—through continuation of the price freeze—while government fails to contain its own spending. The parallel market dollar exchange rate—traditionally a barometer of public confidence in the economy—rose sharply last week to its highest level in three years. If public confidence in the Cruzado Plan drops sharply, Sarney probably will consider additional measures to prevent the left from strengthening its prospects in the crucial November elections. [redacted] 25X1 25X1 25X1

Bolivian Request for Economic Aid

President Paz Estenssoro is increasing pressure on the United States to reciprocate his willingness to cooperate in antinarcotics efforts by agreeing to a long-term aid package for Bolivia. According to the US Embassy, Paz plans to send a delegation, including the Ministers of Finance and Planning, to Washington next week to ask for financial backup in the foreign exchange market, resources to continue the fight against narcotics over the long term, and mechanisms to accelerate development assistance. Members of the Bolivian delegation will emphasize the economic fallout from the anticocaine drive—and the political risks Paz took in agreeing to a direct US military role. The long-fragile Bolivian economy has been struggling in the face of the collapse of the tin market and recurrent strikes. The government crackdown on the illegal cocaine industry in the past month has added to the economic problems by precipitating a run on the peso, depressing prices for coca leaves grown by thousands of peasants, and disrupting the vast, drug-related underground economy. [redacted] 25X1

[redacted] 25X1

Thailand Anticipating Record Rice Exports

The Ministry of Commerce announced on 1 August that 1986 rice exports could surpass the 1984 record of 4.5 million metric tons, a development that we believe may mute Bangkok's allegations of a "devastating" impact of the US Farm Act on Thai rice exports. After Bangkok reduced its rice export target to 4 million tons this spring, unexpected demand from Brazil, Peru, China, and Vietnam caused a surge in exports. Total volume of rice exports for the first half of 1986 was up nearly 13 percent over the same period last year and the record year of 1984. The value of rice sales was down 14 percent from last year, however, because a larger share of these exports were cheaper, lower quality grades. [redacted] 25X1

Communist

Soviets Criticize Western Technology Controls

A midlevel Soviet foreign trade official has admitted that the USSR is circumventing the COCOM embargo. In an interview with a Swedish journalist, he accused Stockholm of reneging on its neutralist policy and of bowing to US pressure by implementing new controls on technology exports to the USSR, and he hinted at a tougher Soviet line toward Sweden. The official asserted that the embargo will hurt Swedish exports without affecting the USSR because Moscow can get foreign technology from other neutrals and through secret trade with Western countries. He acknowledged the embargo causes delays and provides an incentive to collaborate with other countries to develop technology. The official's statements are the first such public admissions. The unusual forum, the frankness of the remarks, and the apparent official sanction of the interview may signal a more open approach to Western export controls, in line with General Secretary Gorbachev's domestic policy of more open media discussion of sensitive issues. The Soviets also may be attempting to warn neutrals who may have a larger stake in trade with the USSR not to follow Sweden's lead. [redacted] 25X1

Soviet Commission Discusses Supply and Price Reforms

[redacted] the Commission on Improving Management, Planning and the Economic Mechanism (Talyzin Commission) is discussing allowing manufacturers of producer goods to directly negotiate contracts for the sale of above-plan output. Sellers and buyers would negotiate under a price ceiling established to prevent excessive profits and inflation. The proposal is intended to give buyers more influence over producers and give producers greater incentive to promptly deliver more quality output. Despite General Secretary Gorbachev's backing—he alone among the Politburo members advocated elements of this proposal at the March Party Congress—such a proposal threatens the power of the supply and planning organs and economic ministries, and officials of those bodies are likely to try to block it. Nonetheless, the measure's impact would be negligible unless planned output targets are lowered and stabilized to encourage enterprises to produce more than token above-plan output. [redacted] 25X1

Czechoslovak Economy Not Responding to Structural Changes

According to recently released data, Czechoslovak economic performance during the first six months of the year was in line with the slow growth trend of recent years although slightly stronger than the first half of 1985. The plan fulfillment report was accompanied by an unusually strong critique of the poorer-than-planned performance. Prague is attempting to reorient production away from energy- and raw-material-intensive industries toward higher value-added sectors as part of a modernization drive. The regime was unable, however, to restrict growth in energy-intensive mining and metallurgy, boost productivity in manufacturing, or improve the quality and technical sophistication of manufactures, as it had hoped. Czechoslovakia's leaders have failed to establish incentives that would move their desired structural change forward—relying instead on calls for management discipline. As a result, the country faces continued slow, below-target, growth for the year. 25X1

Yugoslav Price Increases Revoked

The government has stepped up its battle against inflation—now running at a near-triple-digit rate—by ordering a rollback in the prices of some 200 products to the level of two months ago. Tougher price controls, including a de facto price freeze for many items, were enacted in June. More recently, the government announced new sanctions against violators of price controls, including threats of dismissal and prison sentences for managers. In recent weeks, however, implementation of its price policy program has been marked by indecisiveness and disorganization. The willingness and ability of Premier Mikulic's government to hold the line on price controls could become a test of its ability to implement its broad economic recovery program. While the government can probably count on modest support from the Communist Party, it will be forced to balance public demands for price stability against increasing pressures from industrial organizations to relax price restrictions and threats from producers to undermine price policies. 25X1

Chinese Labor Reforms

China appears to be on the verge of implementing a nationwide labor reform package aimed at gradually replacing the centralized system of assigned jobs and lifetime tenure with fixed-term contracts. In late June, the China began a 105-day suspension of new hiring and transfers in state-owned offices and factories, according to a credible Hong Kong newspaper account. The report, citing an internal Chinese Communist Party document, also disclosed that the state will provide temporary unemployment insurance to contract workers who lose their jobs under the new system. By making it easier for mangement to release employees, these reforms are aimed at raising enterprise productivity and market responsiveness, and cutting back the number of redundant workers. A Hong Kong press report in May suggested that, during the Seventh Five-Year Plan (1986-90), Beijing hopes to trim "surplus" employment in state enterprises by 15 million workers, out of a total of 86 million employees in the sector. The Chinese press has recently expressed concern about finding new jobs for these workers, many of whom they hope will be absorbed into collective and private-sector jobs. 25X1

CAAC Faces Down Kickback Scandal

The Director General of the Civil Aviation Administration of China (CAAC), Hu Yizhou, recently told foreign aviation officials in Beijing that they must take "drastic actions" to help halt recurrent rumors of bribes and kickbacks from foreign aviation companies. Foreign commercial aviation officials have vehemently denied stories that Hu's predecessor accepted bribes on foreign aircraft sales to China, but a CAAC official's evasion of a reporter's question during a May 1986 press conference has fueled the gossip. Despite persistent rumors of his arrest, US Embassy officials say the former director was conspicuously present during the May 1986 Aerospace Exhibition in Beijing—a move some CAAC officials speculated was designed to squelch these reports. In response to Hu's plea, State Planning Commission Vice Minister Gan Ziyu has agreed to meet with representatives of foreign firms to offer suggestions on how to convey their concerns to the State Council. US diplomatic officials note that one US aviation corporate head has already written to Deng Xiaoping personally, assuring him of his company's innocence and expressing concern over the possible long-term damage that could be done to Sino-US commercial aviation relations. 25X1

China Stages Trade Fair in Moscow

China is holding a three-week trade exhibition in the Soviet Union—its first since 1953—featuring more than 4,000 industrial, consumer, and military items, including a model of China's Long March-3 rocket, satellites, computers, televisions, textiles, and handicrafts. Although the show has not yet resulted in any contracts, it has drawn considerable press attention in both countries, and has attracted more than 20,000 visitors daily. According to US Embassy reporting, the Soviets have played up the exhibit—highlighting the countries' common interest in "socialist construction"—as part of Moscow's recent overtures to Beijing: Premier Ryzhkov paid a visit the day of Gorbachev's Vladivostok speech. The Chinese exhibit appears designed to publicize China's economic growth, according to the Embassy; Chinese press accounts have reported the Soviets' interest in "the vitality of China's economy as reflected in the exhibits." At the opening of the fair, the two countries signed a protocol on exchanges of trade exhibitions through 1990. According to Chinese customs statistics, trade between the two countries more than doubled last year over 1984 levels, to nearly $2 billion. 25X1

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